2001

Comment Letter on April 2001 Exposure Draft - Independence, by International Federation of Accountants

Independence Standards Board

ISB
Independence
Standards
Board

June 2001

Technical Director
International Federation of Accountants
535 Fifth Avenue
26th Floor
New York, NY 10017

Dear Sir:

Comment Letter on April 2001 Exposure Draft - Independence

The staff of the Independence Standards Board appreciates the opportunity to comment on your April 2001 Exposure Draft. The Board of the ISB has not considered these matters and reaches conclusions only after extensive due process and deliberation. Consequently, the comments below reflect the staff's views and should not be attributed to the Board or to any Board member.

We congratulate the Ethics Committee for an excellent document and are very pleased to see the continuing convergence of our views with yours. We intend, for example, to recommend to our Board a revised definition of independence in our conceptual framework document that is quite similar to the one included in your ED.

Our comments on specific matters follow:

Impair vs. Compromise

A dictionary definition of impair is "to make worse." In connection with our conceptual framework project we concluded that using the word impair as you do in paragraph 8.8 ("influences that impair professional judgment") could be misinterpreted. Therefore we use the word "compromise" and explain the difference as follows: "An auditor's objectivity is 'impaired' if it is negatively affected to any degree; objectivity is 'compromised' if the impairment rises to the level of precluding unbiased audit decisions."

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Definitions

Audit client

- We believe the definition regarding related parties should apply to private companies as well because the threats from such relationships are the same.

Independence

- In describing independence of mind the ED uses the term "impair professional judgment," whereas for independence in appearance the ED says "unacceptably impaired." Do the terms mean the same thing?

- We suggest that independence in appearance be defined as the third party concluding that the firm or auditor lacks independence of mind to show the linkage between the two concepts.

- It would be helpful if the document provided guidance to auditors and others on how they should assess whether "a reasonable and informed third party…would reasonably conclude [that] integrity, objectivity or professional skepticism had been unacceptably impaired."

Office

- As used, the definition should end with "…or practice lines."

Paragraph 8.7

- We believe that other "independence decision makers," such as audit committees and management, should and will also use the document to assess auditor independence, and therefore they should be referred to specifically in this or another paragraph.

Paragraph 8.8

- see discussion under "Definitions" above

Paragraph 8.22

- We recognize the necessity for the "unless they are prohibited from complying" language. We believe, however, that the audit firm still should be required to make an assessment as to whether in such situations its independence would be compromised or would appear to others to be compromised. If the firm concludes its independence would be compromised, then the firm should decline the engagement even if the reason for the compromised independence is compliance with the law. This self-assessment should also be required in paragraph 8.136.

Paragraph 8.29

- We would make a distinction between immediate family members and close family members. We would prohibit any employment of immediate family members of those on the engagement because the self-interest and familiarity threats arising from such employment, because of either financial or emotional ties, are too great to be overcome by any safeguard other than removal. We also believe that in the vast majority of cases such a requirement would not involve any significant cost because others could replace any affected professionals.

Paragraph 8.35 (d)

- We suggest that the examples of safeguards within the assurance client include the appropriate "tone at the top" – clear and regular messages from the audit committee and senior management emphasizing the company's commitment to fair financial reporting.

Paragraph 8.38

- We suggest specific acknowledgement that compensation and promotion policies which reward quality audits and professionalism play an important role in supporting auditor independence.

Paragraph 8.40

- If there are situations where the new requirements are more stringent than existing ones, you might consider "grandfathering" those relationships that are acceptable currently. This in our judgment would be reasonable and would permit an earlier effective date because existing relationships would not have to be unwound. Under such circumstances, we would suggest an effective date – for new relationships – six months after the issuance of the final statement.

Paragraph 8.106

- In cases where the disposal period is long (say more than thirty days), even if the disposal is at "the earliest practical date," we believe the self-interest threat is too great to be mitigated by any safeguards. We also believe such financial interests

would fail an appearance test. The affected professional should be prohibited from serving on the engagement.

Paragraph 8.107

- We repeat the comment above regarding "earliest practical date." On the other hand, we believe that materiality should be measured against the net worth of both the relative and the audit professional. As we said in our letter of August 14, 2000, we do not believe an investment by, for example, an adult child of the auditor that is material to the child but trivial in relation to the net worth of the auditor would compromise, or appear to compromise, the auditor's independence.

Paragraph 8.108

- We understand that service as a trustee (at least in United States) creates fiduciary responsibilities to the trust. Such responsibilities would, in our judgment, compromise the auditor's independence even it the auditor is not a beneficiary or the interest is not material to the trust. Furthermore, even if there is no significant influence over investment decisions, knowledge of the investment by the auditor combined with the fiduciary responsibility as trustee could have a compromising effect on independence.

Paragraph 8.112

- We agree, except that we would also prohibit joint negotiations for a financial interest in a closely-held company, regardless of materiality.

Paragraphs 8.114/115/116

- We do not believe that allowing audit client loans to the audit firm or to a member of the assurance team satisfies a cost-benefit analysis. Although one could argue that an immaterial loan from an audit client would not jeopardize the auditor's independence, we believe that even immaterial loans are bound to raise questions about favorable terms and the appropriateness of the relationship between auditor and client.

- The document states, in paragraphs 8.114 and 8.115, that the loan or deposit "would not create a threat to independence." Similar language is used in other paragraphs. In addition to disagreeing with the conclusions, as discussed above, we believe it may be more accurate to acknowledge that there is a threat but that in IFAC's judgment it is not significant enough to impair [compromise] the auditor's independence.

Paragraphs 8.117/118

- We do not believe the audit firm or member of the assurance team should be making, holding or guaranteeing any loans by or to an audit client, regardless of materiality. We believe the very act of engaging in the transaction, or monitoring an ongoing relationship, compromises objectivity and the appearance of objectivity.

Paragraph 8.120

- An interest in a closely held entity normally involves negotiations directly with the entity or another shareholder of the entity, as contrasted with the impersonal process of buying stock in a traded company. Furthermore, by definition, the number of shareholders in a closely held entity is small, and the opportunity – and in some cases the need – for contacts between and among shareholders is high. Consequently, we believe the familiarity and self-interest threats, as well as the appearance concern, are too strong to permit the firm or a professional on the engagement to have any interests in a closely-held entity along with the client or a director or officer of the client.

Paragraph 8.129

- In addition to the safeguards described, there should be assessment of the relationship between remaining members of the audit team and the former professional now in a responsible position at the client. The purpose would be to replace those team members whose objectivity might be compromised by their familiarity or respect for their former colleague.

Paragraphs 8.148-156

- We agree with the conclusions in these paragraphs except we do not believe it is necessary to have a limitation on the size of the fees for the services permitted by 8.155.

Paragraph 8.178

- We believe the reference to paragraph 8.144 should be 8.1

Paragraph 8.184

- We do not believe that requiring management to make the decisions on employment of senior managers of the company can mitigate the threats identified in this paragraph. The process of interviewing candidates and identifying those who should be referred to the client represent important decisions which should not be delegated to the audit firm. On the other hand, we believe it is acceptable and reasonable for members of the assurance team – or others from the audit firm - to interview candidates previously selected by the company.

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Paragraphs 8.187-188

- We believe there are situations when the size of the fees relative to the firm, or a subset of the firm, depending on how it is organized, are so material that the only safeguard is to decline the engagement. In other cases discussion of the situation with the audit committee might be appropriate. We have proposed a project on that subject to our Board because it is so pervasive and difficult.

Paragraph 8.189

- We do not agree that disclosure of unpaid fees in the financial statements or assurance report is an effective safeguard. Readers will not know how to evaluate the information. There may, however, be cases where the past due unpaid fee is so large that it creates a self-interest threat that can only be resolved by declining to serve as the continuing auditor. Guidance on when that point is reached would be helpful.

Paragraph 8.195

- We believe there should be a presumption that actual or threatened litigation by the client involving the audit should require the auditor to withdraw. The other safeguards described are unlikely to mitigate the threats created by such a lawsuit. We also believe that declining to continue to serve as the auditor should be required when there is any other litigation between the firm and the client that is either material to either party or raises questions about the client's integrity or willingness to be candid with the auditor.

Other

- There is no guidance regarding investment companies, including independence requirements relating to the investment advisor and other investment companies in the same group. The rules issued recently by the U.S. Securities and Exchange Commission include such guidance, based generally on ISB Standard No. 2, and we encourage you to include such guidance in your pronouncement.

- There is also no guidance regarding what in the United States are known as alternative practice structures. This would include formal and informal affiliations with auditing firms in other countries or cities, or with providers of other services. A fuller discussion of the arrangements and independence issues can be found in ISB Discussion Memorandum 99-2.

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We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Arthur Siegel
Executive Director

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